Fordham Journal of Corporate & Financial Law

Volume 1, *Number* 1 1996 *Article* 7

M&A: Survival of the Fittest in the 21st Century: Strategic Positioning in the Banking and Communications Industries - M&A in the Banking Industry Investment Banking Perspective

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M&A IN THE BANKING INDUSTRY INVESTMENT BANKING PERSPECTIVE *

Neil McCarthy **

INTRODUCTION
WHY SO MANY BANK MERGERS?

I would like to begin with a discussion of the competitive environment facing banks today and then continue with a financial analysis of the dynamics which are driving so many bank mergers and acquisitions.

Today, banks are facing disintermediation from increased competition on all fronts.[1] Larger players in the industry with economies of scale tend to receive the greatest benefit from technological advances, particularly in the use of computers. For the last twenty years, legal barriers to expansion and acquisition have been falling down both geographically[2] and by product line.[3] Furthermore, in the last five years, market dynamics and the pricing cycle favor bank acquisitions. Today banks are relatively profitable and have strong asset quality; however, they have

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* This speech was part of a symposium held at Fordham University School of Law on March 12, 1996 entitled **M & A: Survival of the Fittest in the 21st Century, Strategic Positioning in the Banking and Communications Industries.**

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[1] *Technology May Usurp Investment Banker Skills-HSBC*, REUTERS LTD., June 25, 1996. The article defines disintermediation as, "a process where issuers borrow directly from investors, bypassing banks." *Id.*

[2] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified in scattered sections of 12 U.S.C. (1994)) (amending Douglas Amendment prohibitions on interstate banking and permitting states to allow interstate branching) [hereinafter Riegle-Neal Act]; *see also* Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System, 472 U.S. 159 (1985) (permitting interstate banking through regional compacts).

[3] 12 C.F.R. § 225.25 (1996) [61 FR 14464] (providing the current "laundry list" of permissible nonbanking activities).

relatively low growth prospects.[4] The confluence of all these factors has been driving the rapid rate of bank consolidations in the last five years.[5]

I DISINTERMEDIATION

Typically banks act as the middleman in financial services. They originate financial products by taking money in as deposits and other borrowings, and putting that money out as loans, thus serving as the intermediary between depositor and borrower. [6] In doing so banks serve as a credit check on borrowers. They also process transactions through the payment system.

Banks used to have an exclusive ability to deliver these services as a "bundle." Today customers no longer need the services as a "bundle" as specialized companies who are able to provide some of these services more competitively are increasingly taking business away from banks.[7] For example, by almost any measure, GE Capital is one of the ten largest financial institutions in the country.[8]

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[4] *See, e.g.,* James R. Kraus, *Buyouts, Belt-Tightening Bolster East Coast Banks*, AM. BANKER, Apr. 24, 1996, According to this article, "[f]irst-quarter [1996] earnings climbed at midsize banks across the Northeast and Middle Atlantic states, spurred by acquisitions and cost controls," in line with analysts' expectations with underlying fundamentals looking good. *Id.*

[5] Steven Lipin, *Joining Fortunes: Chemical and Chase Set $10 Billion Merger, Forming Biggest Bank,* WALL ST. J., Aug. 28, 1995, at A1 (indicating that the Chemical-Chase bank deal, the largest ever, came at a time of quickening consolidation in the banking industry as companies search for ways to cut costs, or seek out new business lines or territories). "It also comes at a time of weakening earnings growth for many banks amid signs that revenue growth will be increasingly difficult to find." *Id.*

[6] *See generally* James R. Smoot, *Financial Institutions Reform in the Wake of VALIC,* 29 CREIGHTON L. REV. 691, 692 n.5 (1996) (defining banks as institutions engaged in taking deposits and making loans); *Id* at 694 (indicating that banks underwrite the credit risk of their borrowers).

[7] A. William Schenck 3d, Comment: *Consumers, Not Wall Street, Driving Bank Mergers,* AM. BANKER, May 30, 1996, at 4 (indicating that in the early 1980's, banks held about 50% of the financial assets in the U.S., but today, barely hold one-third). According to this comment, "[t]he biggest impact on bank deposits in the last twenty years resulted from high returns offered by investment products, cash management accounts, money market funds, mutual funds, and securities." *Id.*

[8] Juliana Ratner, *GE Capital Buys Servicing Portfolios from AmSouth and Wachovia,* AM. BANKER, Apr. 17, 1995, at 12 (reporting a race between GE Capital and Countrywide Credit Industries for the number one rank in mortgage servicing business).

A. Money Management

A generation ago, it was hard to do much with your money except to put it into a bank deposit.[9] Wall Street and others, however, have come up with lots of ways to compete with banks for funds. Most notably, money market funds,[10] largely an innovation of the 1970's, compete directly with bank deposits for customers interested in short or long-term interest-earnings accounts.[11]

B. Business Lending

Today, businesses are funding themselves without banks, unlike a generation ago. In the past, even large investment grade corporations would automatically go to a bank for a loan when they needed funds. This is no longer true. Changes in the way securities laws work, particularly the shelf-registration provision of Rule 430(a), allow these companies to raise funds directly through the use of publicly traded debt and commercial paper without the need for banks as middlemen.[12] Many of these corporations have higher credit ratings than the typical money center bank, and can raise funds more cheaply.[13] Another innovation of the 1980's was high yield debt ("junk bonds"). Now large non-investment grade companies can also raise funds directly without having to rely on a bank for a loan. Banks used to have a clear competitive edge in small business lending; but this is no longer the case.

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[9] James McCormick, *Transforming Banks into Capital-Efficient Intermediaries*, AM. BANKER, Sept. 20, 1985 (stating that banks once held an oligopolistic position in bank deposits and other intermediary service which were ostensibly protected by regulation, but has now been eroded by competition and healthy innovation from nonbank competitors).

[10] *Current Conditions Necessitate Interstate Expansion,* AM. BANKER, Apr. 14, 1986 (explaining how securities firms have lured deposits away from banks through the offering of money market funds).

[11] Karen Kahler Holliday, *Will Bank Mergers Destroy Customer Loyalty?,* U.S. BANKER, Oct. 1, 1995, at 30. According to this article, consumers "have bypassed bank certificates of deposit and savings accounts for mutual funds . . . ." *Id.*; James R. Kraus, *The Worlds Largest Banks*, AM. BANKER, July 29, 1993 (indicating that depositors are moving their funds into mutual funds to capitalize on higher rates of return).

[12] John C. Coffee, Jr., Article: *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration,* 52 WASH. & LEE L. REV. 1143 (1995), The article states that shelf registration is a "system under which issuers can obtain quick access to the capital markets by incorporating by reference '34 Act filings." *Id.*, at 1145.

[13] *See, e.g.,* Smoot, *supra* note 6, at 697. According this article, "the commercial paper market has enabled the American businesses to sell their instruments of indebtedness directly to persons and entities with savings available for investment." *Id.*

The MONEY Store, a non-bank specialty finance company, for example, is now the largest issuer of Small Business Administration ("SBA") loans in the country.[14]

C. Consumer Lending

Banks also had a competitive advantage in the 1980's in residential mortgages. Trouble arose when they found out how illiquid and interest-rate sensitive the assets were. Today, banks are facing competition in residential mortgage lending from government-sponsored enterprises (GNMA, FNMA, and FHLMC), specialized mortgage banks such as Countrywide, and large non-banks.[15]

In auto loans, banks compete with the finance subsidiaries of auto manufacturers (so-called "captives"), and specialized companies, like Olympic[16] and Mercury.[17] The captives have an incentive to provide favorable financing to "push metal" for their parent companies. The specialized companies have proven to be highly effective marketers. As a result, banks have had a declining market share of auto finance.[18] Banks have also lost market share in credit cards to specialty companies such as MBNA and First USA.

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[14] James B. Arndorfer, *Nonbanks Getting in on the Fight for Turf,* AM. BANKER, Mar. 11, 1996, at 5. According to this article, banks have been losing their grip as the sole source of credit for small companies, "[i]ndeed, the country's largest SBA lender isn't even a bank; it's The MONEY Store, a Sacramento, California-based company that cranked out $403 million in SBA loans." *Id.*

[15] *See e.g.,* James H. Saft, *Merrill Lynch Finds Brisk Demand for its Secured 100% Mortgages,* AM. BANKER, Nov. 18, 1993, at 10 (indicating that Merrill achieved more than $1.5 billion in originations during 1993).

[16] John R. Engen, *Hard Driving Auto Lender Battles the Banks,* AM. BANKER, Aug. 23, 1995, at 5 (noting that Olympic Financial Ltd., is the nation's third largest securitizer of auto receivables with 14 hubs and 31 spokes covering 31 states).

[17] Gordon Matthews, *Mercury Financial Seen as Bargain After Selloff Spurred by Rate Rises,* AM. BANKER, Jan. 31, 1995, at 24 (indicating that Mercury, which focuses on loans to buyers of used cars, grew rapidly after its spin-off from First Illinois Corp.).

[18] *See* Engen, *supra* note 16. According to this article, Mr. Mack, CEO of Olympic Financial Ltd., is of the opinion that "banks miss the boat on auto loans. They typically demand 20% downpayments - often required by the regulators . . . [and] try to lend in places where they lack a presence." *Id.; see also* Matthews, *supra* note 17. According to the article, "Mercury . . . focuses on loans to buyers of used cars, a specialized sphere of consumer finance generally shunned by banks because of the high risk borrowers involved." *Id.*

D. Securitization

Much of the change in consumer lending has been driven by securitization. Non-bank financial companies can fund mortgages, auto loans and credit cards without the need for deposit-taking branches by securitizing the loans they originate as mortgage- or asset- backed securities. The impact of securitization is possibly the most significant development in finance over the last decade. More than one half of all mortgages in this country are securitized, for example.[19]

II TECHNOLOGY

Advances in technology have continued to revolutionize banking. Computers continue to allow for more efficient information processing with economies of scale. ATMs have changed the way we all handle cash. Credit card companies could not do ten years ago what they routinely do today with point of sale terminals to verify purchases and cash advances.

We are on the verge of cyber-cash on the Internet.[20] In five or ten years, banking and financial services could largely be done in a radically different way. There will be an emphasis on economies of scale which create competitive advantages for larger companies that ultimately leads to third party "outsourcing" and the reduction or elimination of the need for certain jobs.[21]

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[19] Peter J. Ferrara, *The Regulatory Separation of Banking from Securities and Commerce in the Modern Financial Marketplace*, 33 ARIZ. L. REV. 583, 595 (1991). Citing FEDERAL DEPOSIT INSURANCE CORPORATION, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY, 9 (1987). This article states that "[t]wo-thirds of all new mortgages each year are financed through securities rather than traditional lending." *Id.*; *see also* William M. Isaac, Comment: *Government Hobbling Banks in their Fight for Market Share,* AM. BANKER, Apr. 2, 1993, at 4 (indicating that securitized home mortgages as a percentage of total home mortgages grew from about 3% in 1972 to 40% in 1992).; Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers,* TEX. L. REV., May 1991, 1369, 1373-1375 (defining "securitization").

[20] Tanja Lian, *Banking on the Internet: Searching for a Competitive Edge,* BANK MARKETING, July 1, 1995, at 34 (indicating that banks are setting up informational world wide web pages yet remain cautious about using the world wide web as a funds delivery system).

[21] *See, e.g.,* Edward D. Herlihy et al., *The New Aggressive Era in Financial Institutions Mergers & Acquisitions,* MERGERS AND ACQUISITIONS OF FINANCIAL INSTITUTIONS 1995: AN UNPRECEDENTED YEAR OF CONSOLIDATION. AN ANNUAL REVIEW OF LEADING DEVELOPMENTS (PLI Corporate Law & Practice Course

III LEGAL BARRIERS

A. Geographic Barriers

A generation ago, banks were kept small by geographic legal barriers.[22] Historical bias against large banks dates back to Andrew Jackson. There has been an historic effort in our country to keep banks small and local for fear of finance and "Wall Street." Barriers, both at the state and federal level, made it difficult or impossible for banks to expand beyond their natural geographic region.[23] Change occurred in the 1980's. Lawyers, using loopholes like bank holding companies and the regional bank compacts, were able to find ways around geographic barriers.[24] Ultimately, these barriers crumbled.

B. Thrifts vs. Banks

Banks were barred from owning thrifts (savings and loans) until only recently. Thrifts were a statutory creation to promote home ownership. Congress allowed thrifts to pay higher rates on deposits but limited them to making residential mortgages. This arrangement worked well while interest rates remained stable, but then blew up in the late 1970's and early 1980's from interest rate gyrations.

The initial Congressional response was to allow thrifts to make commercial loans, but still prohibit banks from buying thrifts. This resulted in a debacle of epic proportions. Banks can now buy thrifts, subject to issues

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Handbook Series No. 279, 1995). This article indicates that "Increasing economies of scale and improvement in technological and distribution efficiencies have been cited as motivating some of the year's biggest transactions, and will likely play an increasingly important role in shaping the destiny of all industry participants." *Id.*

[22] *See also* John Byrne, *Sound Off*, AM. BANKER, Sept. 24, 1990, at 2. According to this article, "[t]here are two barriers - geographic and legislative - that must be broken down .... which have fostered the development of a fragmented banking system." *Id.*

[23] *See generally* Riegle-Neal Act, *supra* note 2.

[24] *See, e.g.*, 12 U.S.C. § 30 (1996). The Act provides a loophole, known as the "thirty mile rule," which enables banks to overcome geographic barriers and relocate their corporate headquarters.

related to sharing the costs for the S&L bailout. In general, the barriers between thrifts and banks have fallen by the wayside.[25]

C. Commerce vs. Banking

Barriers between commerce and banking, however, still continue to exist. The Bank Holding Company Act (BHCA) essentially prohibits banks, defined as an entity that takes deposits and makes commercial loans, from being owned by industrial companies and vice versa.[26] But, the BHCA does not prevent non-bank specialty companies and institutions like GE Capital, and the captive auto finance companies discussed above, from effectively acting like banks.[27] These non-banks only have to limit certain activities to avoid the BHCA. In the case of GE Capital, for example, it does not take deposits, but instead funds itself in the capital markets and then competes with banks in lending on almost all fronts.

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[25] *See* Mark David Wallace, Comment, *Life in the Boardroom After FIRREA: A Revisionist Approach to Corporate Governance in Insured Depository Institutions,* 46 U. MIAMI L. REV. 1187, 1250 (1992). According to this comment, "thrifts were 'frozen by both statute and regulation' to a one-product business: long-term home mortgage loans. Eventually, the limitation on thrift activities sank the industry while commercial banks, though also limited, retained broad enough powers to survive with adequate diversification." *Id.*

[26] Bank Holding Company Act of 1956, Pub. L. No. 56-511, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. § 1841-50 (1996)). Section 1843(a)(2) states that "no bank holding company shall ... retain, direct or indirect ownership or control of any voting shares of any company which is not a bank or bank holding company." *Id.*

[27] *See* Charlotte L. Tart, Comment, *Expansion of the Banking Industry Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Is the Banking Industry Heading in the Right Direction?*, 30 WAKE FOREST L. REV. 915, (1995). This comment states that " [t]he banking industry, the traditional provider of deposit and loan services, has been challenged by nonbank financial service providers that offer alternatives to investment and credit opportunities without being subject to the banking regulatory environment." *Id.*

D. Investment Banking vs. Commercial Banking

The Glass-Steagall Act of 1933[28] separated investment banking activities from commercial banking activities. Neither entity could be "primarily engaged" in both commercial loans and the business of underwriting securities.[29] This separation has been significantly breached in recent years.[30] The Federal Reserve Board has reinterpreted the term "primarily engage"[31] and many money center banks, most notably, J.P. Morgan, now compete with investment banks through so-called "Section 20 subsidiaries."[32]

[28] Glass-Steagall commonly refers to four sections of the Banking Act of 1933, Pub. L. No. 66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.). The four sections are: § 16, 48 Stat. 184 (codified as amended at 12 U.S.C. § 24); § 20, 48 Stat. 188 (codified as amended at 12 U.S.C. § 377); § 21, 48 Stat. 189 (codified as amended at 12 U.S.C. § 378); § 32, 48 Stat. 194 (codified as amended at 12 U.S.C. § 78).

[29] *Id.* § 20, 48 Stat. at 188 (codified as amended at 12 U.S.C. § 377 (1994)). *See also* David M. Eaton, Comment, *The Commercial Banking-Related Activities of Investment Banks and Other NonBanks,* 44 EMORY L. J. 1187, 1202 (1995). "[N]ational banks and state member banks are proscribed by section 20 from affiliating with any firm 'engaged principally' in securities underwriting." *Id.* at 1194.

[30] Eaton, *supra* note 29, at 1210. According to the comment, "[t]he single great legal barrier which precludes investment banks and securities firms from assuming commercial bank functions, section 21 of the Glass-Steagall Act, which prohibits a company that underwrites and deals in securities from accepting demand deposits, has been circumvented by organizational dodges and equivalency products." *Id.*

[31] *Id.,* at 1199 n.68. According to Eaton:

> [t]he term "principally engaged" was originally defined by the Federal Reserve Board to mean that the affiliate's gross revenues from an individual underwriting, and the affiliate's share of the total market for the activity could not exceed five percent. Later, the percentage threshold for market share was dropped, but the gross revenues cap was maintained.

Id. (citing Citicorp et al., 73 Fed. Res. Bull. 473 (1987); Chemical N.Y. Corp. et al., 73 Fed. Res. Bull. 731 (1987); Bank of New England Corp., 74 Fed. Res. Bull. 133 (1988); Modifications to § 20 Orders, 75 Fed. Res. Bull. 751 (1989) (indicating the Federal Reserve Board's increase of the threshold to ten percent)).

[32] *See* Jaret Seiberg, *38 Banks Getting Head Start on Securities Business Series,* AM. BANKER, May 10, 1996. (noting that the Federal Reserve permitted bank affiliates to engage in underwriting stocks, bonds and other securities through the exemption found in section 20 of the Glass Steagall Act). The article further states "[t]he new powers came with a price. The Fed required the banks to conduct the ... Section 20 affiliate, which must be cut off from the bank. That means separate capitalization, no management interlocks, and no sharing of customer information." *Id.*

IV FINANCIAL ANALYSIS

A. Three Key Ratios

Three key ratios can be used to assess bank profitability. The first is return on assets (ROA) which measures overall profitability of loans and investments, less costs of funding. The second ratio is the equity to assets ratio. It measures the extent that shareholders' investment in the bank is leveraged into loans and investments through deposits and other borrowings. Regulators require certain minimum levels of equity so that banks are adequately capitalized. The third ratio is return on equity (ROE), which measures operating profit for shareholders. Any two of these ratios can be used to mathematically determine the third.

ROA is a quick way to determine how effective a bank is in making money on its investments. It can be thought of as the net spread between what is earned on assets such as loans and the bank's cost of funds, increased by fee income but then reduced by operating expense. In a way, a bank is comparable to a supermarket with high volumes of activity but thin operating margins. Thus a 1.0% ROA is considered good performance, while 1.5% is considered strong, by industry standards. As a result of competitive factors, it is very difficult for banks to improve their ROA beyond 1.5%. Competitive pressure on deposit and lending rates makes it difficult to improve profitability. Banks can best improve their ROA's by becoming more efficient.

B. Market Dynamics/Pricing Cycle

In the last five years, banks have had strong asset quality and profitability relative to the 1980's, which were a time of severe credit troubles and volatile interest rates.[33] As a result, since the 1980's, equity to asset ratios have increased. In recent years, ROAs have been leveling off because of increased competition and the shrinking

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[33] William B. English & Brian K. Reid, *Profits and Balance Sheet Developments at U.S. Commercial Banks in 1994*, Fed. Reserve Bull., June 1995, at 545 (indicating that banks were able to lower loan-loss provisions as loan quality improved due to their past efforts to tighten credit standards).

share of financial services held by banks which is discussed above. With limited growth, equity-to-assets ratios are tending to rise, which tends to reduce a bank's ROE.

As ROAs stagnate, and as equity to assets ratios increase from retained earnings, ROEs have declined. ROE is the most significant measure from a shareholder's perspective, however, as it indicates the return on their stake in the bank. Banks have two ways to address this: (1) reduce their equity-to-assets ratio through share repurchases[34] and (2) increase their ROA through increased efficiencies obtained in mergers.

C. Merger Analysis

I would like to take you through a hypothetical bank merger to make a few points. Exhibit A is a pro forma income statement for a buying bank combined with a selling bank and related adjustments.

Exhibit A
Efficiency Gains and Revenue Enhancements

	Buying Bank	**Selling Bank**	**Adjustments**	**Pro Forma**
Net Interest Income	$5,500	$2,150	-	$7,650
Loan Loss Provision	(500)	(100)	-	(600)
Non-interest income	1,000	400	100	1,500
Non-interest expense	(4,500)	(1,700)	595	(5,605)
Taxes (33.3%)	(500)	(250)	(232)	(982)
Net Income	$1,000	$500	$463	$1,963
ROA	1.00%	1.25%	-	1.40%
ROE	16.67%	16.67%	-	-
Number of shares	1,000	400	-	-
EPS	$1.00	$1.25	-	-

This merger is driven by the synergies which can be obtained. The banks expect an increase of $100 from additional fee income which can be obtained from providing additional services to the smaller bank's customers.

[34] *Id.* According to this article, "some bank holding companies, finding that they had more capital than they considered to be optimal, undertook share repurchase programs." *Id.*

The recent First Union /First Fidelity merger is a good example of this dynamic. First Union believed that it could deliver its broader range of fee-earning products through First Fidelity's branch network.[35]

The critical driver in many bank mergers is the expected cost savings which can be obtained. It is not unusual for banks to hope and expect that by buying a target bank, they can cut thirty-five percent of the target bank's non-interest expense. In some acquisitions, banks even expect to get an even higher level of cost savings.[36] However, these cost savings came from branch closings and mass layoffs.[37] As you can see, in our example, a 35% reduction in the selling bank's non-interest expense reduces the operating expense of the combined banks by $595, or approximately 10% of pro forma operating expense of $5,605. Together with the $100 increase in fee income, the combined bank expects to have after-tax income of $1,963, which is 31% higher than what the two banks would earn separately. The relatively large increase in net income is a result of a bank operating with small profitability margins. Relatively small reductions in expense or increases in income can translate into large increases in bottom-line profitability.

The effect of this from an acquisition standpoint can be demonstrated by an example (See Exhibit B). If we assume that the selling bank has a share price with a 10.0 times price/earnings multiple before the acquisition, it will trade at $5,000 in our hypothetical. But to a buyer this would represent a cost to the acquirer of only 5.2 times,

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[35] Nikhil Deogun, *First Union Takeover of First Fidelity to Bring Terracciano Large Payments,* WALL ST. J., Sept. 5, 1995, at A9 (stating that First Union expects merger to boost reserves by $48 million); Steven Lipin, *First Union Agrees to Buy First Fidelity for $5.5 Billion: Swap Valued at $65 a Share; Combination to Create 7th-Largest U.S. Bank,* WALL ST. J., June 19, 1995, at A3 (indicating that Fidelity relies too heavily on loans rather than fees for its income). The article further states that First Union, with its mutual fund company and recently established investment banking arm which offers corporate banking services such as derivatives and debt securities to middle-market customers, "believes it could expand the sales of these products to First Fidelity's middle-market customers." *Id.*

[36] Joseph Radigan, *Ten Weeks That Shook the World,* US BANKER, Mar. 1, 1996, at 43 (stating that the Chemical/Chase and First Union/First Fidelity deals are examples of how in-market mergers are driven by cost reductions, the dominant force behind bank mergers); Nikhil Deogun, *NationsBank Corp. Buys Bank South and Layoffs Loom,* WALL ST. J., Jan. 10, 1996, at B4 (indicating that top officials estimated a 60% reductions in expenses when NationsBank announced its acquisition of Bank South Corp.).

[37] John W. Milligan, *The Fight for First Interstate,* U.S. BANKER, Mar. 1, 1996, at 32. According to the article, "[m]ost bank mergers rely on a simple formula: combine operations, fire huge numbers of employees to lower costs and declare victory while Wall Street applauds." *Id.*

after factoring in the benefit of assumed cost savings and revenue enhancements, which is incredibly cheap to the buyer. For example, if you assume that the buying bank is itself trading at 10.0 times earnings, it can still buy the selling bank and have an increase in per share earnings for its own shareholders. In fact, as you can see in Exhibit B, the buying bank can afford to pay nearly double the selling bank's share price and still have the acquisition be "accretive" to the buying bank's shareholders.

The dynamic I have just outlined is common place in bank mergers. What it shows is that even well-managed smaller banks can achieve significantly higher valuations as acquisition candidates than they can as independent entities. If the selling bank has a 10 multiple, which is fairly typical if you do not have acquisition "fluff" in a transaction, the selling bank would have a value of $5,000. You can add millions or billions this way; it is the same dynamic.

Exhibit B
Pricing-Buyer's Point of View

Seller's Market Value	Implied P/E Ratio	Value to Buyer*	Implied Price/Book
$5,000	10.0x	5.2x	1.67x
$7,500	15.0x	7.8x	2.50x
$10,000	20.0x	10.4x	3.33x

* With assumed cost savings and revenue enhancements

Differences between pooling and purchase accounting treatment are important in structuring bank acquisitions. In a pooling transaction, the target's balance sheet is simply added with the acquirer's balance sheet without any adjustments. In a purchase, assets must be marked to market and certain other adjustments must be made which are not required in a pooling. These differences can have a significant impact on a bank's required regulatory capital levels and its future reported earnings. Exhibit C shows a

hypothetical pooling transaction. Pooling transactions require use of common stock as the acquisition currency, as reflected below.

Exhibit C
Pooling Accounting - Acquisition for Stock

	Buying Bank	Selling Bank	Pro Forma
Assets			
Cash	$10,000	$4,000	$14,000
Securities	20,000	8,000	28,000
Loans	60,000	25,000	85,000
Premises	10,000	3,000	13,000
	$100,000	$40,000	$140,000
Liabilities & Equity			
Deposits	$85,000	$34,000	$119,000
Other Borrowings	9,000	3,000	12,000
Equity	6,000	3,000	9,000
	$100,000	$40,000	$140,000
Number of Shares (at $9 share)	1,000	833	1,833

Exhibit D is an example of an all cash transaction using purchase accounting. Here the buyer is paying out $7,500 in cash, rather than issuing stock having a value of $7,500 as in the pooling hypothetical. Unlike the case of a pooling, in a purchase a bank's investment in securities, loans and premises is "marked-to-market" to reflect current market value for these assets. These adjustments can sometimes be quite significant because of the effects of interest rate changes and other factors. A purchase transaction will also result in goodwill, to the extent that the consideration paid exceeds the fair market value of the assets acquired.

Exhibit D*
Purchase Accounting-Acquisition for Cash

	Buying Bank	Selling Bank	Adjustments	Pro Forma
Assets				
Cash	$10,000	$4,000	$(7,500)	$6,500
Securities	20,000	8,000	(250)	27,750
Loans	60,000	25,000	(750)	84,250
Premises	10,000	3,000	500	13,500
Goodwill	-	-	5,000	5,000
	$100,000	$40,000	$(3,000)	$137,000
Liabilities & Equities				
Deposits	$85,000	$34,000	-	$119,000
Other Borrowings	9,000	3,000	-	12,000
Equity	6,000	3,000	$(3,000)	6,000
	$100,000	$40,000	$(3,000)	$137,000
*Based on original 400 shares outstanding				

This will often and almost always come up in a purchase transaction of a bank, usually because banks are being sold at a premium to their book value.

Exhibit E shows the differences between reported earnings in a pooling and a purchasing situation.

Exhibit E
Pooling vs. Purchasing:
Effect on Reported Earnings

	Pooling Pro Forma	Further Adjustments	Purchase Pro Forma
Net Interest Income	$7,650	$200	$7,850
Loan Loss Provision	(600)	-	(600)
Non-Interest Income	1,500	-	1,500
Non-Interest Expense	(5,605)	(333)	(5,938)
Taxes (33.3%)	(981)	111	(870)
Net Income	$1,964	(222)	$1,942
ROA	1.40%	-	1.42%
ROE	21.81%	-	32.37%

A pooling transaction will not have any effects on pro forma income beyond the cost savings and revenue enhancements described above. Further adjustments are ordinarily the case in a purchase. Goodwill must be

amortized, which can provide certain tax benefits, but will almost always have a significant adverse effect on reported GAAP earnings. Certain other adjustments must be made to reflect changes in the carrying values of assets which have been marked-to-market.

Purchase accounting was an important issue in the First Interstate transaction.[38] It was a disadvantage that Wells Fargo had to overcome. I believe that it is going to be a major issue in future bank mergers. What I am alluding to is that when you do a purchase, which is required in a hostile transaction, you must give yourself the ability to buy back shares. This requires you to amortize the goodwill over time. Goodwill is a non-cash charge, a single accounting entry.

It tends to punish a purchase transaction on a reported basis. With high equity-to-assets ratios, I believe you are going to find more banks pursuing purchases instead. Although the reported earnings are lower, it allows the purchaser to buy back shares.

The market has not fully understood this concept. When it is realized, you will find that more transactions look better than they seem. This is because cash earnings are actually higher than the GAAP reported earnings for a purchase transaction. To demonstrate this point, Exhibit F shows another hypothetical transaction.

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[38] *See* Roger Lowenstein, *Intrinsic Value, A Modest Proposal to Stop 'Pooling'*, WALL ST. J, May 9, 1996, at C1 (explaining that the advantage of using the 'pooling of interests' method of accounting for mergers rather than the 'purchase' method is purely cosmetic and that Wells Fargo, in an exception to the trend, used the purchase method in acquiring First Interstate. Other banks are watching to see how shareholders react to this method of accounting for a merger which has the effect of reducing reported net income for many years due to the amortization of goodwill).

Exhibit F
Cash Acquisition

	Buying Bank Before	Selling Bank Before	Buying Bank After Pooling	Selling Bank After Pooling	Buying Bank After Purchase	Selling Bank After Purchase
Net Income	$1,000	$500	$1,071	$893	$1,942	-
Shares Outstanding	1,000	400	1,000	833	1,000	-
Pro Forma Ownership	-	-	55%	45%	100%	-
Cash EPS	$1.00	$1.24	$1.07	$2.23	$1.94	-
Cash EPS Accretion	-	-	7%	123%	94%	-
Multiple	9.0x	10.0x	9.0x	-	8.0x	-
Buyer Share Price	$9.00	-	$9.64	-	$15.54	-
Seller Share Price	-	$12.50	-	$20.09	-	18.75

The buying bank earns one dollar a share and trades at a nine times multiple. The stock is thus trading at nine dollars. The selling bank stock is trading at $12.50. This first shows a pooling transaction where the selling bank shareholders get stock worth $20.09, but the buying bank's stock still appreciates to $9.64 because of the synergies which can be obtained. A purchase transaction can be even more compelling, when adjusted for the non-cash goodwill amortization which arises from purchase accounting.

CONCLUSION

As in every transaction, there are winners and losers. The winners are the shareholders of the banks and the mortgage borrowers. The shareholders gain the increased capital gains in the stock price, and the mortgage borrowers gain with decreased mortgage rates. Unfortunately, the losers are the employees and managers of the target banks. Each consolidation transaction results in layoffs.[39] Therefore, the number of financial service industry employees will continue to decline as consolidations occur in the future.

[39] N.R. Kleinfield, *The Downsizing of America: In the Workplace Musical Chairs; The Company as Family No More,* N.Y. TIMES, Mar. 4, 1996, at A1 (discussing the layoffs pursuant to the Chemical/Chase merger).